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In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-22

IVAN ALLEN COMPANY,
Petitioner,

vs.

UNITED STATES OF AMERICA,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY BRIEF ON BEHALF OF PETITIONER

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TABLE OF CONTENTS

The Statute Requires That Earnings and Profits—Not Liquid Assets—Be Compared with Business Needs and Taxpayer Has Never "Conceded" Otherwise 1

The Government's Position, Based Solely on a Test of Corporate Liquidity, Subverts Congressional Policy of Minimizing Intrusion into Legitimate Financial Decisions Made by Corporate Management 3

Conclusion 5

Table of Authorities

CASES

American Trading and Production Corporation v. *United States*, 362 F.Supp. 801 (D. Md. 1972), *aff'd per curiam*, 474 F.2d 1341 (4th Cir. 1973) 5

Smoot Sand & Gravel Corp. v. *Commissioner*, 274 F.2d 495 (4th Cir. 1960), *cert. denied*, 263 U.S. 976 (1960) 2

STATUTES AND REGULATIONS

Internal Revenue Code of 1954, 26 U.S.C.—

§533(a) 1, 2

§534 4

§535(c) 4

§537 4

Small Business Tax Revision Act of 1958, 72 Stat. 1606 (1958) 4

OTHER AUTHORITIES

S. Rep. No. 1622, 83rd Cong., 2d Sess. (1954) 3, 4

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This Reply Brief is filed for two purposes: (1) to correct the Government's misconceptions of Taxpayer's position; and (2) to expose the inconsistency between the Government's position and congressional policy reflected in amendments to the accumulated earnings tax provisions.

THE STATUTE REQUIRES THAT EARNINGS AND PROFITS—NOT LIQUID ASSETS—BE COMPARED WITH BUSINESS NEEDS AND TAXPAYER HAS NEVER "CONCEDED" OTHERWISE

In its Brief the Government states, without citation, that Taxpayer "concedes" that the applicability of Section 533(a) depends upon "an examination of the extent to which its liquid assets exceed its reasonably anticipated business needs" (G. Br. 8). Taxpayer, however, has never made any such concession, and in fact has always maintained that liquid assets are significant for purposes of the accumulated earnings tax "solely as a measure of the corporation's earnings and profits available for use in its business" (P. Br. 11). Taxpayer's position is that the

applicability of Section 533(a) depends upon a determination of whether a corporation's *earnings and profits* reflected in its liquid assets exceed its reasonable business needs.

The Government and Taxpayer are in agreement that the applicability of the Section 533(a) tax avoidance presumption may not be decided by a perfunctory comparison of a corporation's total earnings and profits with its business needs (P. Br. 10; G. Br. 7-8). But this does not mean that the Government may totally ignore the statutory language and substitute liquid assets for earnings and profits in determining whether a tax avoidance purpose will be presumed.[1] The approach that harmonizes the liquid assets analysis with the statutory language of earnings and profits is that urged by Taxpayer—a corporation's liquid assets should be taken into account in the amount at which those assets reflect the corporation's investment of earnings and profits. In this case the amount of Taxpayer's investment of earnings and profits in its liquid assets,

1. The extent to which the Government's liquidity analysis departs from the statute is well illustrated by the Government's erroneous statement that the statutory presumption would be applicable if Taxpayer's total earnings and profits were compared with its reasonable business needs (G. Br. 30). The Government bases this conclusion on a comparison of Taxpayer's total earnings and profits with its working capital need alone (G. Br. 30 n.15). The proper amount to compare with Taxpayer's *total* accumulated earnings and profits, however, is obviously Taxpayer's *total* business needs, including its business needs represented by its fixed assets. Taxpayer's business needs for fixed assets would add in excess of $1,300,000 (Appx. 112, 118) to its stipulated need for working capital (Appx. 56) for each of the years in question and its total business needs thus exceeded its total earnings and profits for each of such years. Similarly, if this statutory comparison is made in the "short-hand" fashion adopted by *Smoot Sand & Gravel Corp.* v. *Commissioner*, 274 F.2d 495 (4th Cir. 1960), *cert. denied* 362 U.S. 976 (1960), and its progeny, so that only Taxpayer's current business needs are taken into account without regard to its need for fixed assets, the proper comparison is with Taxpayer's earnings and profits available to meet its current needs—the earnings and profits represented by or invested in its liquid assets.

including its marketable securities, is the cost of those assets, not the ephemeral appreciation in market value reflected in one day's stock market quotations.

THE GOVERNMENT'S POSITION, BASED SOLELY ON A TEST OF CORPORATE LIQUIDITY, SUBVERTS CONGRESSIONAL POLICY OF MINIMIZING INTRUSION INTO LEGITIMATE FINANCIAL DECISIONS MADE BY CORPORATE MANAGEMENT

Taxpayer recognizes that an inevitable tension exists between the accumulated earnings tax and the freedom of corporate management to conduct its financial affairs without fear of hindsight verdicts on its business judgment. In proceedings leading to the enactment of the Internal Revenue Code of 1954, Congress was made aware of criticisms of the accumulated earnings tax on this ground, but concluded that the penalty tax should be retained as a "safeguard against tax avoidance." Senate Finance Committee Report, S. Rep. No. 1622, 83rd Cong., 2d Sess. 68 (1954). The response of Congress to these criticisms, however, was to enact several amendments to the 531 tax, all of which reflect a policy of minimizing the degree to which this penalty tax infringes upon legitimate corporate business decisions.[2] For example, the 1954 Code

2. In this regard, the Senate Finance Committee Report, S. Rep. No. 1622, 83rd Cong., 2d Sess. (1954) states:

> "Numerous complaints have been received that this provision is prejudicial to small business, that it has been applied in an arbitrary manner in many cases, and that it is a constant threat to expanding business enterprises. Fear of the penalty tax is said to result frequently in distribution of funds needed by the corporation for expansion or other valid purposes.
>
> "The House and your committee believe it is necessary to retain the penalty tax on unreasonable accumulations as a safeguard against tax avoidance. However, several amendments have been adopted to minimize the threat to corporations accumulating funds for legitimate business purposes and to restrict the application of the provision in the case of small companies." *Id.* at 68.

provided in Section 535(c)(2) for a minimum credit equal to $60,000 of earnings and profits, which was subsequently raised to $100,000 by the Small Business Tax Revision Act of 1958, 72 Stat. 1606. Certainly if Congress had intended that liquidity, including the unrealized appreciation in asset value, be the primary test of tax avoidance intent, it would not have provided for a credit measured by earnings and profits, which, as the Government concedes, excludes unrealized appreciation (G. Br. 28).[3]

The most onerous intrusion that would result from adoption of the Government's position would be the forced conversion of appreciated assets and the substantial loss that would necessarily attend such conversions (P. Br. 17-18). The Government argues that the forced conversion of assets results from the operation of the 531 tax itself and not from the position urged by the Government (G. Br. 32-33). This contention, however, begs the ultimate question. It is undisputed that the adoption of the Government's position would require a taxpayer (a) to distribute all of its current earnings as dividends and (b) to resort to the unrealized appreciation in its assets to finance its business needs. Taxpayer recognizes that the accumulated earnings tax requires the conversion of liquid assets to the extent necessary to release earnings and profits invested in those assets. A fair application of the statute

3. Other examples of amendments to the accumulated earnings tax which reflect the Congressional policy of minimizing the conflict between operation of this penalty tax and legitimate corporate business decisions are: the provision that the reasonable needs of a corporation's business shall include "the reasonably anticipated needs of the business" (Section 537); the provision for a procedure to shift the burden of proof to the Government in Tax Court proceedings (Section 534); other revisions to the accumulated earnings credit [Section 535(c)]. Congress recognized that the increased flexibility provided to corporate management by these amendments would cost the Government $10 million in decreased revenues for one year alone. Senate Finance Committee Report, *supra*, at 72.

demands this much, for otherwise the tax could be avoided by any form of investment of earnings and profits. The position urged by the Government, however, would force corporations to convert assets to reach unrealized appreciation as well. Neither the statute nor underlying policy of deterring tax avoidance requires a corporation to finance its business needs by resorting to the unrealized appreciation in its assets, rather than by using its earnings and profits. This point is at the heart of Taxpayer's case, just as it was an essential ground of the decision in *American Trading*.[4]

CONCLUSION

For the reasons stated herein and in Petitioner's previously filed brief on the merits, the judgment below should be reversed.

Respectfully submitted,

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4. 362 F.Supp. 801 (D. Md. 1972), *aff'd per curiam*, 474 F.2d 1341 (4th Cir. 1973). The Government recognizes that this point was an essential ground of the court's holding in *American Trading* (G. Br. 26). A fair reading of that opinion shows that the "distinctions" urged by Amicus Curiae are vastly overstated, and basically irrelevant to the proposition for which it was cited in Taxpayer's Brief. *See* 362 F.Supp. at 808-810.